National Credit Union Administration

Office of the Chairman

January 14, 2011

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing and Urban Affairs
U.S. Senate
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Johnson:

As Chairman of the Board of the NCUA, I am writing to call your attention to an ongoing trend reported by some credit unions that adversely affects consumers—including those of modest means, who benefit from access to the reasonably priced financial services that credit unions offer. Some financially healthy, well-capitalized credit unions that offer desirable products and services are discouraged from marketing them out of concern that attracting share deposits from new and existing members will inflate the credit union's asset base, thus diluting its net worth for purposes of prompt corrective action (PCA).

Under PCA, a credit union's classification among five statutory net worth categories is determined by its "net worth ratio"—the ratio of retained earnings (the numerator) as a percentage of total assets (the denominator). 12 U.S.C. 1790d(o)(3). As a credit union accepts new share deposits, its total assets rise. Unless a credit union's retained earnings grows commensurately, the rising denominator will dilute the credit union's net worth ratio. As a credit union's net worth ratio declines, so does its classification among the net worth categories, exposing it to an expanding range of mandatory restrictions imposed by law, as well as discretionary restrictions imposed by regulation—all designed to restore net worth. *Id.* §1790d(c); 12 C.F.R. Part 702, Subpart B.

For example, a credit union's decline from "well capitalized" (a net worth ratio of 7 percent or greater) to "adequately capitalized" (a net worth ratio between 6 and 6.99 percent) triggers a mandatory "earnings retention requirement" that compels the credit union to annually transfer 40 basis points of net income to build net worth. 12 U.S.C. 1790d(e). A credit union's decline from "adequately capitalized" to "undercapitalized" (net worth ratio between 4 and 5.99 percent) triggers not only the "earnings retention requirement," but also three further mandatory restrictions: a freeze on its asset balance, a freeze on its Member Business Loan balance, and the requirement to obtain NCUA approval of a Net Worth Restoration Plan ("NWRP"). *Id.* §1790d(f) and (g). A further decline below "undercapitalized" subjects a credit union to all four mandatory restrictions plus a series of further discretionary restrictions. *Id.* §1790d(b)(A); 12 C.F.R. 702.203, 702.204.

The risk of reputational damage from being branded less than well capitalized and in need of "restoring" net worth, and from being subjected to the mandatory and discretionary restrictions that accompany a falling net worth ratio, is reportedly having a significant chilling effect on the willingness of some "well capitalized" credit unions to accept new share deposits. In effect, the reward for their success in attracting new shares is the risk of a demotion to a lower net worth category if accepting those shares drives down the credit union's net worth ratio. In turn, the net effect on existing and new credit union members is that they cannot fully rely on the financial institutions that are supposed to be the most accessible to persons of modest means who have the least consumer choice.

It is clear that controlling accelerated, unmanageable growth of credit union assets was a principal purpose of PCA, and NCUA's implementing regulations reflect that goal. It is for that reason that in the course of implementing PCA over the last 9 years, NCUA did not propose statutory remedies in response to occasional periods of reluctance by credit unions to grow assets. That reluctance in the present period of national economic distress has become acute, however, warranting a statutory remedy. Surely it was never the objective of PCA to discourage manageable asset growth by financially healthy credit unions in times of economic distress. To the extent PCA does so now, it does not contribute to the objective of "resolv[ing] the problems of insured credit unions," 12 U.S.C.1790d(a)(1); it unintentionally creates a problem for them, which redounds to the detriment of consumers.

I believe two legislative remedies would help reverse the disincentive to accept new share deposits—one that addresses the "total assets" denominator of the net worth ratio, and another that addresses the "retained earnings" numerator. With respect to the denominator, I encourage Congress to consider allowing qualifying credit unions to exclude from the "total assets" denominator those assets that have a zero risk-weighting, exposing the credit union to virtually no risk of loss. An example of such "no-risk" assets is short-term Treasury securities.

To qualify for exclusion of no-risk assets from its denominator, I propose that a credit union should be required to meet at least two criteria: (1) Maintain a minimum net worth classification, as determined by the NCUA Board, calculated *before excluding no-risk assets;* and (2) demonstrate that share growth is the cause of its declining net worth ratio, *i.e.,* that the decline is not due to poor management or material unsafe or unsound practices. Permitting the "total assets" denominator to exclude "no risk" assets would moderate the growth of assets due to the inflow of new shares, while still imposing PCA that is appropriate to the circumstances.

With respect to the numerator of the net worth ratio, I encourage Congress to consider authorizing qualifying credit unions, as determined by the NCUA Board, to issue additional forms of capital to supplement their retained earnings. To ensure the proper authority, alternative forms of capital would be subject to necessary regulations addressing safety and soundness criteria, investor protections, and any impact on the cooperative credit union governance model.

Congress already permits low-income designated credit unions to offer uninsured supplemental capital accounts to non-members. 12 U.S.C. 1757(6); *see also* 12 C.F.R. 701.34. Modifying the Federal Credit Union Act ("Act") to permit qualifying credit unions to offer uninsured alternative capital instruments subject to regulatory restrictions, and expanding the Act's definition of "net worth" to include those instruments, would allow well-managed credit unions to better manage net worth levels under varying economic conditions.

The legislative remedies suggested above would, I believe, go a long way toward removing an obstacle to accepting new shares, thereby enhancing consumers' access to the benefits of credit union service. Please do not hesitate to contact me should you have questions or wish further information about this proposal.

Sincerely,

Debbie Matz
Chairman

Copy to: Board Member Gigi Hyland
Board Member Michael Fryzel